IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1978

No. 77-1359

UNITED STATES OF AMERICA,
Petitioner,

v.

KIMBELL FOODS, INC.,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR NATIONAL COMMERCIAL FINANCE CONFERENCE, INC. AS AMICUS CURIAE

A. BRUCE SCHIMBERG
ROBERT D. MCLEAN
WILLIAM F. LLOYD
MICHAEL J. SWEENEY
Sidley & Austin
One First National Plaza
Chicago, Illinois 60603
Attorneys for Amicus Curiae National Commercial Finance Conference, Inc.

October 25, 1978

INDEX

CITATIONS

Cases

Statutes

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1978

No. 77-1359

UNITED STATES OF AMERICA,
Petitioner,
v.
KIMBELL FOODS, INC.,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR NATIONAL COMMERCIAL FINANCE CONFERENCE, INC. AS AMICUS CURIAE

SUMMARY OF THE FACTS

This case involves a controversy over the priority of two ordinary security interests in equipment and inventory, both of which were duly perfected by filing under Article 9 of the Uniform Commercial Code (hereinafter "the U.C.C." or "the Code"). The first was granted to Kimbell Foods, Inc. ("Kimbell") and the other to Republic National Bank of Dallas ("Bank"). A ninety percent interest in the Bank's secured claim was eventually assigned to the Small Business Admin-

istration ("SBA"), and that secured claim is owned by both the Bank and the SBA. The debtor, O.K. Supermarkets, Inc. ("O.K."), was not alleged or proven to be insolvent at any time relevant to this case.

O.K. owned and operated a chain of supermarkets. Kimbell is a wholesale grocer which for several years sold grocery inventory to O.K. on a weekly basis. In November, 1968, to secure two promissory notes delivered by O.K. to Kimbell, O.K. executed and delivered to Kimbell a security agreement which granted to Kimbell a security interest in existing and after-acquired equipment and inventory at O.K.'s supermarkets. The security agreement provided by virtue of a standard future advance clause that the collateral also secured the repayment of subsequent liabilities arising from periodic sales of inventory on credit to O.K.[1] Interest and attorneys fees were also secured.

The security interest granted to Kimbell was duly perfected in November, 1968, by filing with the Secretary of State of Texas in accordance with the provisions of the Texas Uniform Commercial Code (App. 46–47). The filing included a copy of the security agreement, thereby making public all the terms of the secured arrangement, including the future advance clause. (App. 16–25). As of November, 1968, there were no other security interests in O.K.'s assets.

Three months later, in February, 1969, O.K. borrowed $300,000 from the Bank which was concurrently secured by a security interest in substantially the same coliateral previously given to Kimbell (App. 47–48). The Bank's security interest, granted under an ordinary security agreement, was

[1]The SBA took the position below that these liabilities were not intended to be within the scope of the future advance clause. The court ruled to the contrary, and the SBA has stated that this is not an issue before this Court. Petitioner's Brief at 8–9 n.11.

duly perfected by filing under the Texas Uniform Commercial Code on February 18, 1969 (App. 48). The SBA conducted its own appraisal of O.K.'s assets, and at the time of the loan guaranteed 90% of O.K.'s liability to the Bank (App. 48).

The Bank and the SBA were aware of the prior secured claim of Kimbell. On the date of the Bank loan, Kimbell's secured claim consisted of the unpaid balance on the notes and $18,390.93 for periodic inventory purchases covered by the future advance clause (App. 47). Proceeds of the Bank loan were used in part to pay the outstanding balance on O.K.'s notes to Kimbell, leaving the other indebtedness of $18,390.93 unpaid (App. 48).

No funds were advanced, directly or indirectly, by the SBA to O.K. The position of the SBA from the outset was that of an ordinary unsecured guarantor with a contingent liability to the Bank. No reference to the SBA guaranty appeared in the security agreement between O.K. and the Bank, and no financing statement or other filing at the time of the Bank loan mentioned the SBA (App. 67).

For almost two years after the Bank loan, Kimbell extended credit to O.K. on a weekly basis for sales of inventory in reliance upon its prior perfected security interest (App. 48). On January 15, 1971, Kimbell stopped selling to O.K. At that time the outstanding liability of O.K. to Kimbell was $18,258.57, substantially the same as it had been at the time of the Bank loan (App. 49). The amount of Kimbell's claim consisted simply of the amount of sales less payments received (App. 76–84). An action to recover this debt was filed by Kimbell on January 15, 1971 (App. 49).

On February 3, 1971, O.K. and the Bank agreed to a sale of collateral located at three of O.K.'s supermarkets, with the proceeds to be held in escrow pending resolution of the priority

of claims to the collateral represented by those proceeds. This agreement was approved by the SBA and Kimbell. The aggregate sale price of the collateral was $95,000.[2]

The SBA honored its guaranty and paid $252,331.93 to the Bank on February 3, 1971, which represented 90% of O.K.'s indebtedness to the Bank (App. 49–50). In consideration for this payment to the Bank, the SBA received an assignment of a 90% interest in the Bank's secured claim.[3] This was the first time that SBA funds were advanced in connection with the Bank's loan to O.K. Until that time the SBA was a contingent unsecured creditor.

Kimbell obtained a judgment in state court against O.K. on February 4, 1972, in the amount of $24,445.37 (App. 27–29). This represented the exact amount of O.K.'s principal debt to Kimbell, as reflected on the statements of account in January, 1971 ($18,258.57), plus interest ($1,186.80) and attorneys' fees ($5,000). This case arose when Kimbell brought the present suit in the United States District Court for the Northern District of Texas, seeking a declaration that its perfected security interest in the proceeds of its collateral held in escrow had priority over the claim of the Bank and the SBA (App. 8–15).

INTEREST OF AMICUS CURIAE IN THIS CASE

The National Commercial Finance Conference, Inc., *amicus curiae* in this case,[4] is a non-profit membership corporation organized under the laws of Delaware, with its principal office in New York. The Conference is the national trade association for the commercial finance and factoring industry, having almost one hundred and fifty members, including small enterprises and large publicly-held companies as well as nine of the ten largest banks in the United States or their subsidiaries.

[2]Of this amount, $38,000 was attributable to fixtures and equipment and $57,000 was attributable to inventory (App. 49–50).

[3]In anticipation of this action, on January 21, 1971, the SBA filed a form notice of assignment with the Texas Secretary of State under Article 9 of the U.C.C., thereby protecting the SBA from any possible action by the Bank which might release or amend the existing financing statement in the Bank's name. U.C.C. §9-405.

[4]This brief is filed pursuant to written consent of both parties to the case, in accordance with Rule 42 of the Court.

The heart of the commercial finance business is asset-based financing, including equipment leasing and factoring. The most common forms of collateral are inventory, accounts receivable, and equipment. Members of the Conference operate on a national, regional and local scale, extending secured credit to businesses, often through the financing of accounts receivable and inventory on a revolving basis. Most of these businesses are small and medium-sized enterprises, which depend upon the availability of secured financing for their existence and growth. For example, accounts receivable financing often enables a borrower to survive the growth or contraction periods in its business by providing funds prior to the maturity date of its receivables. Similarly, inventory financing allows a borrower to purchase inventory needed for cyclical or seasonal buildups or to supplement cash needs during periods of low volume.

The importance of the commercial finance industry to small business has long been recognized. Twenty years ago, the Board of Governors of the Federal Reserve System reported to Congress as follows:

> Commercial finance companies and factors play a significant role in the financing of small business in manufacturing and wholesale trade . . .
>
> Commercial financing and factoring are particularly significant in a study of small business financing because credit is made available to small businesses that do not have access to bank credit or to the markets for equity and long-term debt funds.

Federal Reserve System, Financing Small Business, Report to the Committees on Banking and Currency and the Select Committees on Small Business, 85th Cong., 2d Sess. 449–50 (Comm. Print 1958).

In response to the rapidly expanding needs of such borrowers, secured financing has grown dramatically and has become a significant part of the national credit market. The annual volume of financing by the commercial finance and factoring industry has increased from approximately $5,000,000,000 in 1950 to over $70,000,000,000 in 1977.

As businessmen, the members of the Conference expect to take risks on secured loans. They know that there is a danger of insolvency and sometimes fraud. They also know that their security interests will be inferior to earlier perfected liens and security interests. Secured lenders therefore review the appropriate public records to determine the relative priority of their security interests in the collateral. This review permits them to consider the highly competitive market price for their loans and services in light of the risks of asset-based financing. The borrowers with whom they will do business and the structure and amount of the secured transaction turn, in large measure, on the established expectations resulting from notoriety of liens and security interests in the public record.

Reliance on public filings has been aided by the widespread adoption of the Uniform Commercial Code, which has discouraged secret encumbrances while permitting flexible security devices designed to satisfy modern commercial needs. In only a decade, the Uniform Commercial Code has developed into a truly national law of commerce, having been adopted in 49 states, Puerto Rico, and the District of Columbia. It has provided uniformity and certainty which

have greatly facilitated and increased the availability of secured lending to small businesses for which credit otherwise is not available.

The government's position in this case is that a government agency can acquire a junior security interest and thereby make it senior. If this Court were to adopt that theory, a substantial risk would be added to the commercial financing industry in this country. A careful secured lender cannot reasonably predict whether the government might decide to provide secured credit, or even an unsecured secret guaranty, on some date following a private senior secured loan. Once the government's presence as a commercial lender is known, the government's position would require a lender providing revolving credit secured by accounts receivable or inventory to terminate financing and liquidate its collateral to preserve its priority position. In most cases, that is not possible without destroying the borrower's business, and in many instances it would also cause irreparable injury to the lender through a loss of the going concern value of its collateral. The economic result of the government's position would be to increase the cost of money to small and medium-sized businesses which are dependent on asset-based financing, and significantly reduce the availability of secured credit to those businesses.

SUMMARY OF ARGUMENT

This is a case of first impression which involves two principle issues. Both issues must be decided in the SBA's favor for it to achieve priority over Kimbell's earlier perfected security interest.

The first issue is whether the choate lien doctrine should be extended to decide the priority of two consensual security interests created pursuant to the Uniform Commercial Code,

outside of the context of the Federal Tax Lien Act and the insolvency priority statute. 26 U.S.C. § 6321 *et. seq.* (1976), 31 U.S.C. § 191 (1976). This issue apparently has never before been raised by the government in this or any other court, although the government's brief conveys the contrary impression. Even in the limited contexts in which the choateness doctrine has been applied, it has been heavily criticized and greatly restricted by Congress, particularly to the extent it has been applied to consensual liens or security interests.

Since the choate lien doctrine first appeared fifty years ago, a uniform body of law governing the priority of consensual security interests in personal property has been adopted nationwide—Article 9 of the Uniform Commercial Code. The federal courts have recognized that the U.C.C. provides the proper source from which to draw federal common law rules, particularly in cases concerning complex commercial security interests. It is to the Code, rather than to the choateness doctrine, that the federal courts should look to measure the adequacy and relative priority of consensual security interests. Reliance upon the U.C.C. would result in a priority system as between security interests which would provide fair, clear, and uniform rules for resolving priority disputes applicable to all parties, including the government.

The second issue, if this Court chooses to extend the choate lien test to the security interests in this case, is whether Kimbell's security interest satisfied that test at the relevant time. Kimbell's security interest was certain as to the identity of its holder, the amount of the debt, and the identity of the collateral as of January 15, 1971, prior to the time that the SBA advanced funds and acquired a 90% interest in the Bank's junior security interest. The government argues that Kimbell's security interest must meet the choateness test as of the time the Bank perfected its interest, in 1969. Both the case law and common sense dictate, however,

that the government cannot make the choateness test applicable retroactively simply by accepting an assignment of a privately-held security interest.

ARGUMENT

I.

THE CHOATE LIEN TEST IS NOT APPLICABLE TO KIMBELL'S PERFECTED SECURITY INTEREST.

This case involves the relative priority of two security interests created and perfected under Article 9 of the U.C.C.[5] Thus, the case is unlike any of the cases on which the government relies. There is no dispute that the Kimbell security interest was granted and perfected first and the Bank's security interest second under the U.C.C. The acquisition of an interest in the junior security interest by any party other than the government could not have affected or even raised a question about the established priority of the Kimbell security interest. The voluntary purchase by the SBA of a portion of the junior security interest did nothing but change the identity of the owner of that interest, long after the parties had relied on their respective positions in extending credit. As a result of this change of ownership, the SBA claims that its interest in the junior security interest now has priority over Kimbell's security interest. The basis of that claim is that Kimbell's security interest is "inchoate."

The Congress, courts and commentators have repeatedly recognized that the choateness doctrine has resulted in unfairness, confusion and uncertainty even in the limited categories of cases in which it has been applied, and the recent trend has been to narrow substantially or eliminate the doctrine. Nonetheless, the SBA now proposes to extend the

[5] TEX. BUS. & COM. CODE ANN. §§ 9.101 *et seq.* (Vernon). Both security interests were created and perfected in Texas.

choate lien test into an entirely new area, where it will serve no function other than to disrupt established commercial expectations of secured lenders, increase the volume of litigation in the federal courts, and unjustly enrich the government acting as a consensual creditor, providing it a windfall at the expense of other secured parties. Such an extension should not be permitted.

A. THERE IS NO STATUTORY OR JUDICIAL BASIS FOR EXTENDING THE CHOATE LIEN TEST TO DETERMINE THE PRIORITY OF TWO CONSENSUAL LIENS OR SECURITY INTERESTS.

The choate lien test has been considered by the courts and by the Congress in several contexts. The thrust of the government's brief is to suggest that the applicability of that test to this case has been previously established. This position is unsupported by any statute or case. Never before has the choate lien test been applied to a determination of the relative priority of two U.C.C. consensual security interests.

1. *The Statutory Framework*

Initially, it is important to recognize that the federal claim in this case does not fall within the scope of any federal statutes governing the priority of liens and security interests. Since no claim is made or evidence offered that O.K. was insolvent, the insolvency priority statute, R.S. § 3466,[6] does not apply. No federal tax lien is asserted, so that the provisions of the Federal Tax Lien Act[7] are not controlling, although the 1966 amendments thereto are useful to demonstrate the direction in which the choate lien doctrine has developed in recent years and the federal policy concerning the doctrine expressed by the Congress. Finally, this is not a bankruptcy proceeding,

[6]31 U.S.C. § 191 (1976).

[7]26 U.S.C. §§ 6321 *et seq.* (1976).

so that the priority provisions of Section 64 of the Bankruptcy Act[8] are not applicable.[9]

Nothing in the language or legislative history of the Small Business Act[10] suggests that Congress intended that the SBA should enjoy the superpriority which it claims here. While that Act is very specific in setting forth the rights and duties of the SBA, the only provision of the Act which deals with the priority of claims of the SBA subordinates such claims to certain state tax liens. 15 U.S.C. § 646 (1976). In testimony in 1958 before the Congressional subcommittee which was considering enactment of that subordination provision, the SBA acknowledged the priority of pre-existing liens without any reference to the possible applicability of the choateness doctrine to such interests:

> [t]he priority enjoyed by the United States under the provisions of title 31, United States Code, section 191, in the distribution of the *unencumbered* assets of any debtor of the United States who has become insolvent or who has made an assignment for the benefit of creditors . . . *is not applicable to property which is subject to a lien of any kind.*[11]

[8]11 U.S.C. § 104 (1976).

[9]If the SBA's security interest, acquired by assignment, had been a tax lien of which notice had been filed on the date SBA acquired a portion of the Bank's interest, it would have been junior to Kimbell's perfected security interest. As is discussed at p. 32 *infra*, a federal tax lien arises at the time of assessment but will not be valid as against perfected security interests until the time of filing. Unlike the tax lien example, the government here did not even have any claim until 1971.

Similarly, if bankruptcy had ensued, the SBA would simply have had a junior secured claim or an unsecured claim governed by Section 64 of the Bankruptcy Act, 11 U.S.C. § 104 (1976).

[10]15 U.S.C. §§ 631 *et seq.* (1976).

[11]Letter from Wendell B. Barnes, Administrator, Small Business Administration, in *Hearings before a Subcommittee of the Senate Committee on Banking and Currency, Credit Needs of Small Business*, 85th Cong., 2d Sess. 553–554 (1958) (emphasis added).

2. *Development of the Choate Lien Test*

The choate lien test is a judicially created and developed doctrine, although its scope has on occasion been limited by statute. The common law priority principle that "first in time is first in right" was recognized by this Court early in the history of American jurisprudence,[12] and has been adopted in this century as the "federal common law" rule determining the relative priority of lien claims of the United States.[13] *United States* v. *City of New Britain*, 347 U.S. 81 (1954). The choate lien doctrine arose prior to the development of the U.C.C.

[12] *Rankin* v. *Scott*, 25 U.S. (12 Wheat.) 177 (1827).

[13] The applicability of federal law to this case is not as clear as the government suggests at pages 16–17 of its brief. *See generally* Comment, *The Relative Priority of Small Business Administration Liens: An Unreasonable Extension of Federal Preference?*, 64 MICH. L. REV. 1107, 1124–1127 (1966). The portion of the security interest held by the government here was not "created in the course of exercising . . . constitutional functions", Petitioner's Brief at 17 n.14; it was a privately created security interest which later happened to be assigned to the SBA. The federal common law principle enunciated in *Clearfield Trust Co.* v. *United States*, 318 U.S. 363 (1943) does not require the application of federal law to every issue in every case to which the United States is a party. There are many circumstances under which the rights of the United States will be decided under state law rather than federal law. *See, e.g., United States* v. *Yazell*, 382 U.S. 341 (1966) (SBA subject to state coverture law); *Aquilino* v. *United States*, 363 U.S. 509 (1960) (state law determines whether taxpayer has rights in property to which a federal tax lien could attach); *United States* v. *Durham Lumber Co.*, 363 U.S. 522 (1960). The widespread enactment of the Uniform Commercial Code has substantially increased the desirability of adopting state law as the governing federal law on commercial law questions, and even the specific holding of *Clearfield Trust* may be far less compelling today than it was 35 years ago. Dunne, *Government Checks: A Leash for Leviathan?*, 95 BANKING L.J. 691 (1978). *See generally* 1A MOORE'S FEDERAL PRACTICE ¶ 0.321 at 3285 (2d ed. 1948).

Consequently, it might well be argued that state law should be applied to priority cases where the federal government acquires a security interest by assignment from a private party. *See United States* v. *Bryant*, 58 F. Supp. 663, 665 (S.D. Fla. 1945), *aff'd*, 157 F.2d

(footnote continued on following page)

as an adjunct[14] of the first in time principle, providing a standard in limited categories of cases for determining the date when a competing lien will be deemed to have arisen.

(a) Insolvency Priority Statute

The choateness doctrine first appeared in cases arising under the insolvency priority statute, R.S. § 3466. In spite of the sweeping language of that statute, enacted early in our nation's history,[15] that in certain kinds of insolvency proceedings "debts due the United States shall be first satisfied," courts had long held that R.S. § 3466 did not give the government priority over prior mortgages.[16] In the early twentieth

(footnote continued from preceding page)

767 (5th Cir. 1946) (state law governs where United States acquires negotiable instrument after maturity). Nevertheless, most lower courts have accepted the applicability of federal law in such cases as a matter of "dogma", without much analysis. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 1054 n.10 (1965). *See, e.g., United States* v. *Eklund*, 369 F. Supp. 1052 (S.D. Ill. 1974). In order to address the critical questions concerning the choate lien test which are discussed herein, this Brief will assume that federal law applies.

[14] The government suggests that "some form of choateness requirement is a necessary complement to the first-in-time rule." Petitioner's Brief at 24 n.24. To the extent that this merely means that some method is required to determine when liens or security interests arise, the statement is neither controversial nor helpful. If it implies that the choate lien test is a logical and necessary consequence of the first-in-time rule, however, it is clearly incorrect.

[15] The predecessor to R.S. § 3466, 1 Stat. 512, 515, was enacted in 1797, using language substantially similar to that which is in force today. *See United States* v. *Moore*, 423 U.S. 70, 80–81 (1975); Kennedy, *From Spokane County to Vermont: The Campaign of the Federal Government Against the Inchoate Lien*, 50 IOWA L. REV. 724, 725 n.3 (1965). The concept of governmental priority has its origins in Magna Carta. W. PLUMB, FEDERAL TAX LIENS 191 (3d ed. 1972).

[16] *Conard* v. *Atlantic Ins. Co.*, 26 U.S. (1 Pet.) 386 (1828); *Brent* v. *Bank of Washington*, 35 U.S. (10 Pet.) 596 (1836). *See United States* v. *Texas*, 314 U.S. 480 (1941); *See generally* Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905, 907–911 (1954), which contains an excellent discussion of the history of the choate lien test.

century, however, this Court began to formulate the principle that in order to defeat the government's statutory priority, a competing lien would have to satisfy a standard of certainty, or "choateness". *New York* v. *Maclay*, 288 U.S. 290 (1933); *United States* v. *Texas*, 314 U.S. 480 (1941); *United States* v. *Waddill, Holland & Flinn, Inc.*, 323 U.S. 1010 (1945); *United States* v. *Gilbert Associates, Inc.*, 345 U.S. 361 (1953). Thus, the choate lien doctrine developed as a limitation on a judicial exception to the literal meaning of the insolvency priority statute. The limitation, however, swallowed up the exception; since the beginning of the development of the choateness test, no lien or security interest has ever been found to be choate under the insolvency priority statute."

(b) Federal Tax Lien Act

The choateness concept was subsequently applied by this Court to determine the relative priority of federal tax liens

"Thus, at least in the insolvency context, the choate lien test has become a rule by which "the government always wins." *See* Petitioner's Brief at 42 n.48. Even the vitality of the venerable "mortgage" cases, *supra*, n.16, has been called into question under the modern reading of § 3466. *United States* v. *Texas*, 314 U.S. 480, 486 (1941); *New York* v. *Maclay*, 288 U.S. 290 (1933); 2 G. GILMORE, SECURITY INTERESTS in PERSONAL PROPERTY 1073 n.3 (1965). There is a growing belief that R.S. § 3466 has become a statutory anachronism, reflecting an outdated approach to the collection of government revenues which developed at a point in history when almost all government claims were tax claims. *See, e.g., H. B. Agsten & Sons, Inc.* v. *Huntington Trust & Sav. Bank*, 388 F.2d 156, 161–62 (4th Cir. 1967) (Haynsworth, J., concurring), *cert. denied*, 390 U.S. 1025 (1968). Reform of the insolvency priority statute along the lines of the 1966 Federal Tax Lien Act was deferred only because it would have complicated the legislative process in view of the overlapping jurisdictions of Congressional committees. *See* Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 293 (1967). While reform of the insolvency priority statute must be left to Congress rather than the courts, reliance upon that statute, rather than the 1966 Federal Tax Lien Act, as a source of federal policy concerning the choateness doctrine would be clearly misplaced.

and state statutory liens, outside the context of R.S. § 3466. *United States* v. *Security Trust & Savings Bank* 340 U.S. 47 (1950); *United States v. City of New Britain*, 347 U.S. 81 (1954). In several cases, the justification for the choateness requirement was set forth: the rule was designed to prevent state statutes from giving statutory liens which protect various kinds of special interests" a "superpriority" by dating them, for the purposes of the first in time rule, at an artificially early point in time. Thus, in *United States* v. *City of New Britain*, 347 U.S. at 86, this Court expressed concern that "a State could affect the standing of federal liens, contrary to the established doctrine, simply by causing an inchoate lien to attach at some arbitrary time even before the amount of the tax, assessment, etc., is determined."

The choate lien test, as developed in earlier cases and enunciated in *City of New Britain*, 347 U.S. at 84, is three-fold: in order for a lien to be choate, the amount due, the identity of the lienor, and the identity of the property subject to the lien must be certain. In the tax lien area, the doctrine was applied for the first time to a pre-U.C.C. consensual lien on personal property in *United States* v. *R. F. Ball Construction Co.*, 355 U.S. 587 (1958) (*per curiam*). No funds had been disbursed in *Ball* at the time notice of the tax lien was filed, which caused this Court to hold the consensual lien to be inchoate. Later, this Court recognized that a consensual lien is capable of satisfying the choateness test without the amount of the debt being reduced to judgment. *Crest Finance Co.* v. *United States*, 368 U.S. 347 (1961) (*per curiam*).

That the choateness doctrine has not been well understood is demonstrated in part by the fact that a great many of this

"The most common kinds of statutory liens to be involved in such cases have been those for state and local taxes and amounts owed to mechanics and materialmen. *See generally* Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905 (1954).

Court's decisions concerning the doctrine have been reversals of lower court decisions. *See, e.g., United States* v. *Pioneer American Insurance Co.*, 374 U.S. 84 (1963); *Crest Finance Co.* v. *United States*, 368 U.S. 347 (1961) (*per curiam*); *United States* v. *R. F. Ball Construction Co.*, 355 U.S. 587 (1958) (*per curiam*); *United States* v. *Vorreiter*, 355 U.S. 15 (1957) (*per curiam*); *United States* v. *Colotta*, 350 U.S. 808 (1955) (*per curiam*).[19] Another measure of the uncertainty associated with the doctrine is the fact that this court has had to decide approximately 20 cases directly relating to the choateness doctrine in the past 50 years, and has denied certiorari in many others. Furthermore, the choate lien doctrine has attracted considerable scholarly criticism, while finding few defenders. *See, e.g.*, 2 G. Gilmore, *Security Interests in Personal Property*, 1052–1073 (1965); Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 Yale L.J. 228 (1967); Kennedy, *From Spokane County to Vermont: The Campaign of the Federal Government Against the Inchoate Lien*, 50 Iowa L. Rev. 755 (1965); Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 Yale L.J. 906 (1954); Comment, *The Relative Priority of Small Business Administration Liens: An Unreasonable Extension of Federal Preference?*, 64 Mich L. Rev. 1107 (1966).

Prior to 1966, the choate lien test had been applied to only a few government consensual liens, none of which arose under the U.C.C. The Court had considered the choateness doctrine under the Tax Lien Act in only three consensual lien contexts: a series of loans secured by assignments of

[19]Professor Gilmore has compared the development of the choate lien test in the lower courts to a "parlor game in which all the players but one try to guess what the remaining player is thinking of", and has observed that the lower courts have had a singular lack of success in discerning the scope and meaning of the choateness doctrine. 2 G. Gilmore, Security Interests In Personal Property 1062 (1965).

accounts receivable (*Crest Finance*), a contingent commitment by a surety company (*Ball Construction*), and attorneys' fees for enforcing a mortgage which were unliquidated in amount until after the notice of tax lien was filed (*Pioneer American Insurance*). The rapid national adoption of the U.C.C., at a time when there was general dissatisfaction with the choate lien doctrine as applied in tax lien cases, led to the Federal Tax Lien Act of 1966,[20] under which the applicability of the choate lien doctrine to tax lien cases was greatly restricted, particularly with respect to security interests perfected under the U.C.C. Congressional dissatisfaction with the choateness doctrine, as applied to security interests, was evidenced by the fact that perfected security interests covering future advances, after acquired property, commitments to make future advances, and attorneys' fees received explicit protection in the 1966 amendments.[21]

The effect of the 1966 amendments was to limit dramatically the application of the choateness doctrine in the only area in which it had been applied by this Court at that time outside the insolvency priority statute. The relative priority of federal tax liens and security interests can now be resolved under the specific terms of the Act, without reference to the choate lien test. One of the major federal policies underlying the 1966 amendments was to harmonize the Tax Lien Act with the provisions of the U.C.C., to prevent or curtail the impairment of modern commercial financing transactions. S. Rep. No. 1708, 89th Cong., 2d Sess., reprinted in [1966] U.S. Code Cong. & Ad. News 3722; *Pine Builders* v. *United States*, 413 F. Supp. 77, 81 (E. D. Va. 1976); R. Henson, *Secured Transactions Under the Uniform Commercial Code* 105 (1973).

[20]Pub. L. No. 89-719, 80 Stat. 1125 (1966).

[21]26 U.S.C. §§ 6323(c)(2), (c)(4), (d) and (e) (1976).

(c) Consensual Liens and Security Interests Held by the Government

Despite continuing scholarly criticism and Congressional action aimed at limiting the scope of the choate lien test, some federal agencies, including the SBA, have become increasingly aggressive in their attempts to extend the doctrine into new areas.[22] In particular, those agencies have urged that the choateness doctrine should be extended beyond the scope of the tax lien and insolvency statutes to priority contests between consensual liens and security interests held by the government and competing statutory liens. This argument has taken on growing significance as the size and number of federal programs under which agencies of the United States acquire such voluntary commercial consensual liens and security interests has increased dramatically.[23]

Several federal courts of appeals accepted the government's position that the choate lien test should be used in cases in which the government holds a mortgage or security interest to determine the priority of various kinds of statutory liens.[24] Each of these cases, however, is entirely different from

[22] *See* Comment, *The Relative Priority of Small Business Administration Liens: An Unreasonable Extension of Federal Preference?*, 64 MICH. L. REV. 1107 (1966).

[23] The government stated in its Petition for Certiorari, at page 6, that the SBA alone now has approximately 3,400 cases in litigation at any given time, many of them involving priority questions. The most recent update to the Office of Management and Budget's CATALOG OF FEDERAL DOMESTIC ASSISTANCE indicates that there are now 1,044 federal assistance programs of various kinds, administered by 55 federal governmental agencies.

[24] *Chicago Title Ins. Co.* v. *Sherred Village Associates*, 568 F.2d 217 (1st Cir. 1978), *petition for cert. pending sub nom. Hercoform Inc.* v. *Chicago Title Ins. Co.* (No. 77-1611); *Willow Creek Lumber Co.* v. *Porter County Plumbing & Heating, Inc.*, 572 F.2d 588 (7th Cir. 1978); *United States* v. *General Douglas MacArthur Senior Village, Inc.*, 470

(footnote continued on following page)

this case. In these cases, the result generally would have been identical under the federal first in time rule even without the application of the choateness doctrine, since the federal mortgage was perfected prior to the filing of notice of the statutory lien.[25] More significantly, however, none of these cases relied upon by the government involved a competing mortgage or perfected security interest created under Article 9 of the U.C.C.; instead, all of them involved competing statutory liens, arising under a myriad of state statutes which provided for the priority of those liens in a variety of different manners, often regardless of the time when notice of the lien was filed or when the amount of the debt secured by the lien became liquidated and certain.[26]

(footnote continued from preceding page)

F.2d 675 (2d Cir. 1972), *cert. denied sub nom. County of Nassau* v. *United States*, 412 U.S. 922 (1973); *United States* v. *Oswald & Hess Co.*, 345 F.2d 886 (3d Cir. 1965); *United States* v. *County of Iowa*, 295 F.2d 257 (7th Cir. 1961); *Southwest Engine Co.* v. *United States*, 275 F.2d 106 (10th Cir. 1960); *United States* v. *Latrobe Constr. Co.*, 246 F.2d 357 (8th Cir.), *cert. denied*, 355 U.S. 890 (1957). Two circuits have disagreed. *United States* v. *Crittenden*, 563 F.2d 678 (5th Cir. 1977), *cert. granted*, 47 U.S.L.W. 3191 (U.S. Oct. 2, 1970) (No. 77-1644); *United States* v. *California-Oregon Plywood, Inc.*, 527 F.2d 687 (9th Cir. 1975); *Ault* v. *Harris*, 317 F. Supp. 373 (D. Alas.), *aff'd*, *Ault* v. *United States*, 432 F.2d 441 (9th Cir. 1970).

[25] *See, e.g., Chicago Title Ins. Co.* v. *Sherred Village Associates*, 568 F.2d 217 (1st Cir. 1978), *petition for cert. pending sub nom. Hercoform, Inc.* v. *Chicago Title Ins. Co.* (No. 77-1611); *Willow Creek Lumber Co.* v. *Porter County Plumbing & Heating*, 572 F.2d 588 (7th Cir. 1978); *United States* v. *General Douglas MacArthur Senior Village, Inc.*, 470 F.2d 675 (2d Cir. 1972), *cert. denied sub nom. County of Nassau* v. *United States*, 412 U.S. 922 (1973); *United States* v. *County of Iowa*, 295 F.2d 257 (7th Cir. 1961); *Southwest Engine Co.* v. *United States*, 275 F.2d 106 (10th Cir. 1960).

[26] In light of the intense scholarly and judicial criticism of the judicially-created choate lien test, *see supra* at pp. 15–16, the steps taken by Congress to limit the doctrine, *see* 26 U.S.C. § 6323 (1976), 15 U.S.C § 646 (1976), and the fact that this Court has never applied the test except under the insolvency and tax lien statutes, a

(footnote continued on following page)

Even in those circuits in which the choateness test has been extended for the benefit of the United States as holder of a commercial mortgage lien to defeat statutory liens, that extension has been accompanied by reluctance and considerable critical commentary. For example, in *Chicago Title Insurance Co.* v. *Sherred Village Associates*, 568 F.2d 217, 221 (1st Cir. 1978), *petition for cert. pending sub nom. Hercoform, Inc.* v. *Chicago Title Ins. Co.* (No. 77-1611), which is quoted in part in Petitioner's Brief at page 46, the Court of Appeals for the First Circuit discussed the undesirability of the choateness doctrine even in the more traditional statutory lien area:

> Choateness has proven a fatal handicap in the race between a mechanic's lienor and a federal lienor. It appears to serve no strong policy, since the federal lienor stands to be enriched by the increase in the property value caused by the work of the mechanic's lienor, while the latter stands without remedy. Moreover, this built-in advantage is not necessary to protect the federal investment; the government in mortgage lending and insuring may choose its debtors and set its terms.

(footnote continued from preceding page)

compelling argument could be made that many of these cases are incorrectly decided or are no longer controlling. *See United States* v. *Crittenden*, 563 F.2d 678 (5th Cir. 1977), *cert. granted* 47 U.S.L.W. 3191 (U.S. Oct. 2, 1978) (No. 77-1644); *Ault* v. *Harris*, 317 F. Supp. 373 (D. Alas.), *aff'd, Ault* v. *United States*, 432 F.2d 441 (9th Cir. 1970). The government itself recognizes that this case is distinguishable from those involving state lien superpriorities. At several points in its certiorari petition in the *Crittenden* case, the government acknowledged that it would be possible for it to lose this case but prevail in *Crittenden*. Petition for Writ of Certiorari at 7, 9, *United States* v. *Crittenden* (No. 77-1644). While there may be substantial justification for this approach to statutory liens, it involves an issue which is raised in *Crittenden* and *Hercoform* v. *Chicago Title Ins. Co.* (No. 77-1611) but which is not present here. Accordingly, the National Commercial Finance Conference takes no position in this brief concerning the appropriate resolution of that question.

That court went on to conclude that it was unwilling to try to develop an alternative to the choateness test in the circumstances of that case. In so doing, however, the First Circuit expressly distinguished this case, acknowledging that the Fifth Circuit's adoption of the U.C.C. "*fitted the case admirably*, since the U.C.C. is of general, nationwide application, with no quixotic parochial variations."[27] 568 F.2d at 222 (emphasis added).

Viewed in a historical perspective, the significance of the government's assertions in this case becomes apparent. The choate lien doctrine arose in conjunction with a judicial exception to a federal priority statute which on its face appeared to be absolute. That exception, however, has been applied in such a way that it has ceased to perform any mitigating function. The choateness concept was then imported into the Tax Lien Act, but its application there was subsequently severely limited by the 1966 Federal Tax Lien Act. Thereafter, the concept was revived by government agencies in some lower courts to defeat special interest state statutory liens creating superpriorities competing with the rapidly growing number of federal consensual security interests and mortgage liens.

Now, however, apparently for the first time, and despite the fact that a uniform priority system for consensual security interests has been adopted throughout this country (except in Louisiana) in the form of Article 9 of the U.C.C., the SBA seeks to extend the choateness doctrine to a priority contest between two ordinary consensual security interests. That proposed extension of the doctrine would serve only to enrich the federal Treasury at the expense of private secured

---

[27] A similar statement was made in the Brief in Opposition of the non-federal respondents before this Court in *Hercoform*. Brief for Chicago Title Insurance Co. and New England Merchants National Bank in Opposition at 7-8, *Hercoform* v. *Chicago Title Ins. Co.* (No. 77-1611).

creditors, while creating uncertainty and confusion in an area of commerce in which stability and certainty concerning the legal effect of contracts are essential. Consequently, the Conference urges this Court to reject this attempt by the SBA to expand the scope of the choate lien doctrine into the field of consensual security interests, where the government acts as a voluntary commercial lender, not a sovereign taxing authority.

B. PERFECTION UNDER THE UNIFORM COMMERCIAL CODE IS THE PROPER BASIS FOR DETERMINING WHICH SECURITY INTEREST WAS FIRST IN TIME UNDER FEDERAL PRIORITY LAW.

Article 9 of the Uniform Commercial Code has been adopted with minor variations by the legislatures of 49 states and Puerto Rico and by the Congress for the District of Columbia.[28] It provides a well thought out, coherent and comprehensive system for the creation, perfection and enforcement of virtually all security interests, and for determining their relative priority.[29] It was to those provisions, rather than to the choate lien doctrine, that the court of appeals properly turned as the source of federal priority law in this case.

---

[28]The undesirability of extending the choateness doctrine to this kind of case is highlighted by Congress' adoption of the U.C.C. for the District of Columbia. The federal common law, of which the choateness doctrine is a part, operates only where there is no superseding federal statutory rule, such as the Federal Tax Lien Act or the Bankruptcy Act. The underlying logic of the choateness doctrine is that the various states should not be allowed to interfere with federal rights through the enactment of state superpriority statutes. Thus, the choateness doctrine has no applicability in the District of Columbia, where the Congress legislates. If the SBA is successful in this case, the choateness doctrine will apparently apply to cases such as this throughout the country *except* in the District of Columbia. The lack of logic in this disparity is readily apparent.

[29]*See particularly* U.C.C. §§ 9-303, 9-312.

Since the creation of the U.C.C., and particularly after its widespread acceptance throughout the United States, the federal courts have repeatedly looked to the Code as an authoritative source of federal common law in cases to which the United States is a party. *See, e.g., United States* v. *Hext*, 444 F.2d 804 (5th Cir. 1971); *United States* v. *Wegematic Corp.*, 360 F.2d 674 (2d Cir. 1966); *In re Yale Express System, Inc.*, 370 F.2d 433 (2d Cir. 1966); *Bumb* v. *United States*, 276 F.2d 729 (9th Cir. 1960); *Matter of Ocean Electronics Corp.*, 451 F. Supp. 511 (S.D. Cal. 1978); *United States* v. *Topeka Livestock Auction, Inc.*, 392 F. Supp. 944 (N.D. Ind. 1975).[30] As Judge Friendly observed in *United States* v. *Wegematic Corp.*, 360 F.2d at 676 (emphasis added):

> When the states have gone so far in achieving the desirable goal of a uniform law governing commercial transactions, it would be a distinct disservice to insist on a different one for the segment of commerce, important but still small in relation to the total, consisting of transactions with the United States.

Article 9 of the Code has been relied upon particularly frequently as the source of the "federal law merchant" concerning security interests.[31] The provisions of the Code provide a fair and simple method for determining the validity and priority of security interests which is well understood by the courts and relied upon in the commercial world. Since the underlying priority principle of the Code is the "first in time" rule applied under the federal common law,[32] it is en-

---

[30]See also 1A MOORE'S FEDERAL PRACTICE ¶ 0.321 at 3285 (2d ed. 1948).

[31]*See, e.g., United States* v. *Hext*, 444 F.2d 804 (5th Cir. 1971); *In Re Yale Express System, Inc.*, 370 F.2d 433 (2d Cir. 1966); *Matter of Ocean Electronics Corp.*, 451 F. Supp. 511 (S.D. Cal. 1978); *United States* v. *Topeka Livestock Auction, Inc.*, 392 F. Supp. 944 (N.D. Ind. 1975).

[32]The Code contains a few carefully delineated exceptions to the pure first in time rule, relating to such matters as purchase money

(footnote continued on following page)

tirely consistent that this Court apply the Code provisions governing the time when security interests such as are involved in this case, whether held by the government or others, are perfected for the purpose of determining their relative priority under the federal rule.

The government complains in its brief that the opinion of the court of appeals in this case leaves some unresolved questions, since it adopts one aspect of the Code to resolve the question in this case, but does not specify what the source of federal law will be for any other priority questions which may arise. This hardly seems a significant problem, particularly when compared to the uncertainty and case-by-case development of common law rules by the federal courts which would necessarily result from an extension of the choateness test. To the extent that this question is considered at this time, however, the Conference believes that established commercial expectations would be best served by complete reliance upon the perfection and priority rules of Article 9, which is based almost entirely on the first in time principle.

The fact that some states may have a few nonuniform Code provisions does not affect the essential uniformity and desirability of using the Code to determine priority. *See* Petitioner's Brief at 50–51 n.56. The possibility of some minor nonuniformity in language or interpretation exists with respect to any part of the Code, but this contingency has done nothing to deter the federal courts from relying upon the Code as a basic source of federal common law rules and, if necessary, following the weight of authority in the rare in-

(footnote continued from preceding page)
security interests and perfection by possession. The existence of those exceptions, however, does not affect the basic comparability of the Code and common law priority rules. The government itself may choose, for example, to perfect by possession (pledges of securities) or finance the acquisition of equipment or inventory under purchase money security interests to attain priority over other secured parties.

stances of nonuniformity. *See, e.g., United States* v. *Burnette-Carter Co.*, 575 F.2d 587 (6th Cir. 1978), *petition for cert. pending* (No. 78-257)[33]; United States v. *Hext*, 444 F.2d 804, 811 (2d Cir. 1971). To the extent that such instances ever arise, they may provide the federal courts with the opportunity to rely upon a clear general set of rules while allowing for flexibility with respect to specific details on which there may be public policy differences in some states.

By looking to the Code to determine which security interest is first in time, this Court will be applying a rule which has been interpreted, explained, and refined by a comprehensive body of precedent, a substantial portion of which has developed in the federal courts. This will lead to a consistency of result which will reduce the need for litigation involving a case-by-case determination of federal priority rules in the area of secured financing, and will help to foster secured lending pursuant to a set of rules that everyone, including the government, understands and relies upon. By contrast, expansion of the choate lien doctrine to cover security interests competing with those held by the government as a voluntary commercial lender will require a prolonged, uncertain, case-by-case consideration by the federal courts of the exact content of the rule in this new context.[34] To exactly what cases will the

[33]In the *Burnette-Carter* case, the application of Article 9 of the U.C.C. as federal common law resulted in a decision in favor of the United States. This was also true in *Matter of Ocean Electronics Corp.*, 451 F. Supp. 511 (2d Cir. 1966).

[34]One issue which may arise, regardless of whether the choateness rule is applied here, is the circuity problem. That problem exists when under applicable law each of three liens or security interests is superior to one of the other two, but junior to the third. Such circuity is the result of superimposing one priority system on top of another. W. PLUMB, FEDERAL TAX LIENS 117 (3d ed. 1972). There is no one perfect solution to this problem, but the one considered most fair was adopted by Congress when it revised Section 67c of the Bankruptcy Act. 11 U.S.C. § 107 (1976); *see generally* 4 COLLIER ON BANKRUPTCY ¶ 67.27 (14th ed. 1940).

(footnote continued on following page)

doctrine be extended?[35] What standard of choateness will be applied?[36] These and other questions, many of which probably cannot be anticipated at this time, would have to be addressed by the district courts, the courts of appeals, and this Court if the choateness doctrine is extended to this case.

Another reason for rejecting the government's position in this case is the bizarre consequence of its application. In cases such as this where the SBA acquires only a partial assignment of a claim, the federal courts will be confronted with the anomaly of a single secured claim which has two different priorities: a first priority for the federally-owned portion, but a third priority for the other portion retained by the private assignor, which is junior to the competing perfected security interest under the Code.

(footnote continued from preceding page)

If this Court affirms the Fifth Circuit's decision in *United States* v. *Crittenden* (No. 77-1644), the circuity problem will be substantially resolved, since the result will be a relatively uniform priority system when the government holds a security interest, even for competing statutory mechanic's liens.

[35]Another question, for example, would be whether the doctrine should be applied in the District of Columbia. *See* p. 22 n.28, *supra*. The applicability of the doctrine to the priority of consensual liens and security interests arising under the federal statutes would also be open to question. *See, e.g.* Federal Ship Mortgage Act, 46 U.S.C. § 911 *et seq.* (1976); Federal Aviation Act of 1958, § 503, 49 U.S.C. § 1403(a)(2) (1976). *See generally* 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 401-61 (1965). These are only a few examples of the uncertainties inherent in the government's position, which demonstrate that the problem is not exclusively one of state law.

[36]*Cf. United States* v. *Vermont*, 377 U.S. 351, 357 (1964) (different standards of choateness applicable under insolvency and tax statutes); *Kimbell Foods, Inc.* v. *Republic Nat'l Bank*, 557 F.2d 491, 502 n.14 (5th Cir. 1977) ("the same reasons that argue against the extension of the choateness doctrine to federal contractual liens would urge us to adopt a less stringent standard of choateness in this context.").

In its brief, the government suggests that application of the choateness doctrine is necessary to uphold "the expected stability of decision." Petitioner's Brief at 39. In fact, the opposite result is mandated by that principle. So far as the Conference is aware, except in cases governed by the insolvency priority statute, the SBA and other federal agencies have never before in this or any other court challenged the priority of Article 9 security interests perfected prior to security interests held by the government. Before this case arose, the commercial finance industry gave little consideration to the prospect that a government lender or guarantor could upset a pre-existing set of priorities of consensual security interests created pursuant to the U.C.C. by use of the choate lien test, particularly when the government relied on the Code to create and perfect its interest. Far from reflecting "expected stability of decision", the position taken by the government represents a significant departure from both past government practice and the existing expectations of private secured lenders. One commentator has characterized the District Court's decision in favor of the SBA in this case as "startling", observing: "This decision raises a frightening specter of federal power and demonstrates the wisdom of applying state law where rights have been fixed and relied upon in structuring contractual relationships." Burke, *Secured Transactions, Uniform Commercial Code Annual Survey*, 31 Bus. Law. 1583, 1586-87 (1976).[37]

The government's brief devotes considerable attention to the need for certainty in matters of commercial law. The Conference, as a trade association of businesses which must understand and consider security priority questions on a daily basis, is in wholehearted agreement with this objective.

---

[37]*See also* Burke, *Secured Transactions, Uniform Commercial Code Annual Survey*, 33 BUS. LAW. 1931, 1936-37 (1978), commenting favorably on the court of appeals' opinon in this case.

The Conference believes, however, that the goal of commercial certainty will be subverted rather than achieved by expansion of the choateness doctrine to resolve priority questions between competing security interests arising under the Code.

Lenders in the secured financing business rely heavily on their ability to evaluate the priority of their security interests. That priority will usually determine whether credit will be extended, as well as on what terms. It is therefore essential to secured lenders and borrowers alike that the law governing priorities be definite, clear, and consistent. This essential certainty would be completely undermined by a rule under which a lender enters into a secured credit arrangement relying upon the knowledge that its security interest has priority under the Code, only to find that a federal agency voluntarily provided an unsecured guaranty of another loan years later, thereby completely rearranging the priorities to transform what would otherwise have been a senior interest into a junior one. This is exactly the sort of retroactive "bootstrapping" which is at the heart of SBA's argument.

The SBA as a voluntary commercial lender or guarantor is in as good a position as any other commercial lender to evaluate the risks associated with a particular loan. Many of the loans made or guaranteed by the SBA may entail more risk than those made by private lenders, because of the statutory restriction on the SBA to provide financial assistance only to the extent that it "is not otherwise available on reasonable terms from non-federal sources,"[38] but the SBA is also expressly directed to obtain adequate security for such loans.[39] Congress clearly intended that the SBA loan program

[38]15 U.S.C. § 636(a)(1) (1976).

[39]15 U.S.C. § 636(a)(7) (1976).

not disrupt the existing credit market.[40] There is no reason why, in choosing to make such loans, the SBA as a voluntary commercial lender should be able to take advantage of a special rule to achieve priority which would be unavailable to any other lender. As Mr. Justice Holmes has stated in another context, "The United States does business on business terms." *United States* v. *National Exchange Bank*, 270 U.S. 521, 534 (1926).

To the extent that the choateness rule is expanded to allow the SBA to defeat secured lenders with prior perfected security interests, every dollar returned to the SBA's "revolving fund" (Petitioner's Brief at 23) will be one less dollar available in the private credit market. There is not a single equitable consideration which warrants that result. Application of the choateness rule in that context would tend to replace private lenders with a public one.

There may be some logic to protecting the government from a myriad of state statutes exalting various kinds of special interest liens retroactively to superpriority status, particularly where the government is unable to take advantage of such provisions on equal terms.[41] There is, however, no justification in the absence of Congressional authorization for immunizing government commercial lending agencies from the rules of nationwide applicability embodied in the U.C.C., of which they can take advantage on the same basis

[40]In its opinion in this case, the court of appeals noted that extension of the choate lien doctrine to this case would be inconsistent with the policy of the Act to strengthen small businesses. *Kimbell Foods, Inc.* v. *Republic Nat'l Bank*, 557 F.2d 491, 500 (5th Cir. 1977).

[41]This is the question presented in *Crittenden* and *Hercoform*. As has been stated above, *supra* n.26, those cases are very different from this one, and the Conference takes no position on them, other than to point out that even in that context the choate lien doctrine has been the subject of substantial criticism. *See supra*, pp. 15–21.

as any other secured lender. The U.C.C. places all voluntary secured lenders, including agencies of the government, on an equal footing and in a position to rely on the notoriety of security interests in the public record.

II.
THE PERFECTED SECURITY INTEREST OF KIMBELL WAS CHOATE AND FIRST IN TIME.

The Conference believes that the proper basis for affirmance in this case is that the choate lien test is not applicable to this transaction. For the SBA to achieve priority in this case, however, it must do more than extend the choate lien test to this non-insolvency, non-tax lien priority contest. To prevail, the SBA must also establish that it can acquire a junior security interest from private lender and thereby make it senior, with priority over a perfected security interest that was fully choate at the time of the assignment. That proposition is unsupportable both in law and in logic, and if adopted would destroy any semblance of order and certainty which might survive the SBA's proposed extension of the choate lien test.

A. FOR THE PURPOSE OF APPLYING THE CHOATE LIEN TEST, THE SBA OBTAINED ITS SECURITY INTEREST ON THE DATE IT FIRST ADVANCED FUNDS AND ACQUIRED AN INTEREST IN A SECURED CLAIM.

The function of the choate lien doctrine has always been to test the certainty of a competing lien or security interest at the time that the federal government acquires its lien or security interest. The SBA's claim in this case depends upon its assertion that the choateness of Kimbell's security interest must be measured as of February, 1969, when the Bank's security interest was perfected. That contention, however, is contrary to both existing authority and common sense.

It is uncontroverted that the SBA did not have a security interest in O.K.'s property in February, 1969, or at any time prior to February 3, 1971, when it acquired part of the Bank's secured claim. The SBA conceded this at oral argument in the court below. 557 F.2d at 505. Nonetheless, the SBA contends that its security interest "attached"[42] in 1969. Prior to February 3, 1971, however, when the SBA honored its guaranty, the SBA had at best an unsecured contingent claim, while the Bank held the entire junior security interest. Consequently, the SBA is claiming that a requirement which is designed to protect security interests and liens of the federal government should be applied retroactively, as of a date when the United States did not possess any security interest or lien and had not advanced any funds.

The Conference agrees that the SBA's assigned interest "relates back" to 1969 under state law, just as it would for any other assignee who acquires the interest of the assignor, subject to all of its limitations. If the Bank's security interest had been perfected in 1965, for example, it would not have lost its first in time priority as a result of the assignment to

---

[42]The use of the concept of attachment in this context (by the government and by some courts) has contributed to the confusion associated with the choate lien doctrine. The government here obviously intends attachment to mean that the security interest which it has was sufficiently complete and effective to be valid for the purpose of applying the first in time rule and the choateness doctrine. The SBA does not describe, however, what is necessary for such attachment to occur.

The more common meaning of attachment is the point at which a security interest becomes enforceable against the debtor. Under the U.C.C., this generally occurs when (a) the debtor has signed a security agreement, (b) value has been given, and (c) the debtor has rights in the collateral. U.C.C. § 9-203. In order to take priority over other security interests, however, "perfection" (usually by filing a financing statement) is also required. U.C.C. § 9-312. Under the Code, it is perfection rather than attachment which determines the relative priority of security interests.

the SBA. That is something very different from relating back the applicability of the choateness doctrine. The assignment to the SBA did not damage the priority position of the Bank's security interest; the government, however, is attempting to use the assignment to *improve* the priority of 90% of that interest, by having the applicability of the federal choateness rule relate back. This is in complete contravention of the basic principle that an assignee acquires no better rights than those which are held by its assignor.

The sort of retroactive application of the choateness doctrine which is urged here by the government has never been permitted in the analogous situation in the federal tax lien area. Such a lien arises automatically at the moment the tax is assessed, 26 U.S.C. § 6322 (1976), which involves nothing more than an entry in government records. The lien is not valid against other perfected consensual liens or security interests, however, until notice of the tax lien is filed. 26 U.S.C. § 6323(a) (1976); *United States* v. *Pioneer American Insurance Co.*, 374 U.S. 84, 88 (1963). Thus, even prior to the restriction of the choate lien test by the Federal Tax Lien Act of 1966, choateness was tested as of the date when notice of the federal lien appeared in the public record. The choateness requirement did not relate back to the date of assessment, despite the fact that a federal lien arises at that time. The notions of reasonable reliance and established expectations which underlay that result in the tax lien area are equally applicable here.

Few courts have addressed this issue directly, but the case law which does exist indicates that the SBA cannot achieve an application of the choateness requirement at a point in time when no federal security interest or lien existed. The opinion of the court of appeals in this case does state that the SBA's security interest "attached" in 1969, 557 F.2d at 503, but it does so only after deciding that the choateness doctrine is inapplicable to this case. Consequently, the Fifth

Circuit did not in any sense sanction the retroactive application of that doctrine to this transaction.

The two cases cited by the government on this subject, *Small Business Administration* v. *McClellan*, 364 U.S. 446 (1960), and *United States* v. *Eklund*, 369 F. Supp. 1052 (S.D. Ill. 1974), do not support a contrary conclusion. In *McClellan*, a bankruptcy case involving the insolvency priority statute, the note held by the SBA was assigned to it after the filing of the petition in bankruptcy. The Court concluded that for the purposes of the insolvency priority statute, there was a "debt due the United States" as of the filing of the bankruptcy petition. It did so, however, on the ground that the original loan was a *joint* one made by both the SBA and a private lender, with federal funds disbursed at the time of the underlying loan, prior to bankruptcy.[43] While the SBA lacked legal title to the note prior to the assignment, "beneficial ownership of the three-fourths of the debt for which priority is asserted belonged to the Administration from the date of the loan." 364 U.S. at 450. No such beneficial ownership is present here, since no federal funds were advanced prior to February 3, 1971.

The *Eklund* decision is also distinguishable on several grounds. First, as in *McClellan*, *Eklund* involved a loan in which the SBA disbursed funds and held a participation interest, rather than simply guarantying a secured creditor. 369 F. Supp. at 1054. Second, that case involved mechanics' liens entitled to a superpriority under state law, rather than security interests whose ordinary priority was determined at the time of their perfection. 369 F. Supp. at 1055. If the case had involved competing security interests perfected at the time of the filing of the mechanics' lien claims, the security

[43] *See Small Business Administration* v. *McClellan*, 272 F.2d 143, 144 (10th Cir. 1959), *rev'd*, 364 U.S. 446 (1960).

interests would have been second in time and therefore junior to the SBA under the U.C.C. Third, the district court seems to have concluded incorrectly that the mechanics' liens became choate when they were recorded. Since the liens probably were inchoate under *United States* v. *White Bear Brewing Co.*, 350 U.S. 1010 (1956) (*per curiam*), it was unnecessary to reach the relation back question (assuming the choateness doctrine was applicable at all[44]). Finally, to the extent that the language of the case suggests support for the government's "relation back" theory, it is directly contradicted by a more recent district court decision. *City of New York* v. *United States*, 414 F. Supp. 90 (E.D.N.Y. 1975).

The principle governing this case is to be found in *United States* v. *Marxen*, 307 U.S. 200 (1939), which was discussed and distinguished in the *McClellan* opinion. The facts in *Marxen* were not unlike those in *McClellan*, except that the federal agency there (the FHA) had merely insured a loan, similar to the SBA's guaranty here, rather than participating in it directly. The Court concluded that there was no debt due the United States at the time of bankruptcy, when the rights of creditors become fixed, and the government therefore was not entitled to priority by virtue of the post-bankruptcy assignment. 307 U.S. at 207.

In subsequent cases, relying upon *Marxen*, courts have consistently held that a security interest assigned to the federal government does not enjoy the special benefits available to federal lien claims as of a date prior to the assignment. *In re Miller*, 105 F.2d 926 (2d Cir. 1939); *Engleman* v. *Commodity Credit Corp.*, 107 F. Supp. 930 (S.D. Cal. 1952); *In re Wood's Estate*, 171 Misc. 542, 12 N.Y.S. 2d 816 (Surrogate's Ct. 1939). *See also Bulls* v. *United States*, 356 F.2d 619, 623 (5th Cir. 1966). Thus, in *United States* v. *Brocato*, 403 F.2d

[44]See note 26 *supra*.

105 (5th Cir. 1968), the court was confronted with a "Deferred Participation" agreement containing a clause which provided that the indebtedness was automatically transferred to the SBA upon the debtor's bankruptcy. The purpose of this provision was to circumvent the *Marxen* decision,[45] but the court refused to sanction this attempt to elevate form over substance. Relying on *Marxen* and *McClellan*, the court stated that for the insolvency priority statute to apply, the SBA must have had either legal title or beneficial ownership of the debt prior to the filing of the bankruptcy petition. In order to have beneficial ownership under *McClellan*, the court stated that "the SBA *must actually advance money* to the debtor prior to the filing of the bankruptcy petition." 403 F.2d at 105 (emphasis added). Since the SBA lacked legal title at that time, and there was "no prior 'beneficial ownership' to which a transfer could relate back", the insolvency statute was held to be inapplicable.

While these cases were concerned with the insolvency priority statute, which is not involved in this case, the principle which they enunciate is equally relevant here.[46] As a voluntary commercial assignee, the government is entitled to the rights possessed by its assignor. Under the insolvency priority statute and the related choate lien test, the government also enjoys some special benefits which are unavailable to other secured creditors in litigation.[47] The clear message of these cases arising under R.S. § 3466 is that the government cannot claim those benefits retroactively, as of a date when the government was not a secured creditor at all. There is

[45]*See* Comment, *The Relative Priority of Small Business Administration Liens: An Unreasonable Extension of Federal Preference?* 64 MICH.L.REV. 1107, 1111-12 n.32 (1966).

[46]The government, by citing *McClellan*, apparently recognizes the relevance of such cases.

[47]As has been described above, however, many of such benefits have been limited or abolished in recent years.

no reason why this should be any less true for the choate lien test than it is for the insolvency priority statute. In fact, there is substantially less justification for retroactivity in the case of the choateness doctrine, which is without statutory basis.

Nothing to the contrary is stated in the cases from some of the courts of appeals applying the choateness doctrine in order to subordinate statutory liens to federal consensual liens. In *Willow Creek Lumber Co.* v. *Porter County Plumbing & Heating, Inc.*, 572 F.2d 588, 590 (7th Cir. 1977), the court apparently recognized that choateness should be tested at the time the assignment was recorded. Referring to the mechanics' liens in that case, the court said:

> These liens were not reduced to judgment on January 2, 1975, the date when the assignment of the mortgage to the United States was recorded. Accordingly, if the federal priority rule applies, the lien of the mortgage is entitled to priority, and the judgment must be affirmed.

A secured party extending continuing credit pursuant to a future advance clause should be able to evaluate its relative priority position under the applicable state law, without having to speculate whether a junior security interest may someday be created and sold to the government and be catapulted to senior status through the retroactive application of the choateness doctrine. As the court of appeals stated in its opinion below, "[i]t was only when the SBA bought into the note in February 1971 that Kimbell could have actual notice of the existence of a federal lien and the application of federal law." 557 F.2d at 505. The application of the choateness doctrine to determine the relative priority of perfected security interests would seriously undermine the commercial certainty which is the foundation of the secured lending industry. The retroactive application of that doctrine would erode that certainty still further.

B. KIMBELL'S SECURITY INTEREST WAS CHOATE AT ALL RELEVANT TIMES.

Kimbell's security interest in O.K.'s property was created and perfected by the three security agreements executed and filed in 1966 and 1968. Thereafter, Kimbell held the senior security interest in that property, both before and after the secured loan by the Bank in 1969. At any point in time, Kimbell's security interest was fully choate under the principles developed by this Court; most particularly, that security interest was choate on February 3, 1971, when the SBA first acquired any interest in the Bank's security interest in the property.

As developed by this Court, the choate lien test merely requires that the identity of the lienor, the identity of the collateral, and the amount of the debt secured must be certain. *United States* v. *City of New Britain*, 347 U.S. at 84. Each of these elements was satisfied in the present case. Only the last element is contested by the government.

The government's sole challenge to the choateness of Kimbell's security interest relates to the third element of the choate lien test, concerning the certainty of the amount of the debt. Despite the government's contentions to the contrary, however, that element was satisfied. The amount which O.K. owed Kimbell changed from time to time, as O.K. made payments to Kimbell and Kimbell sold more inventory to O.K.[48] At any point in time, however, the amount of this contractual debt was fixed, certain, and liquidated in amount. For example, in February, 1969, when Republic made its loan to O.K., the debt was $18,390.93. From January 15, 1971 forward, the amount of the debt was fixed at $18,258.57, a few dollars less than it had been at the time of

[48] Similarly, the amount of the debt secured by the Bank's security interest changed, as interest accrued and payments were made.

the Republic loan. This is the exact amount of the principal claim for which Kimbell obtained judgment, plus interest and attorney's fees.[49]

The controlling case on this point is *Crest Finance*. The government has apparently misunderstood the facts in *Crest Finance*, arguing that it is distinguishable because there "the amount due was established by the face amount of the lienor's note."[50] That was not the fact or the issue in that case.[51] As the Solicitor General's office acknowledged in *Crest Finance*, when it confessed error on behalf of the government, the debtor there had executed not one but nine separate notes, and a substantial part of the aggregate principal amount of those notes had been repaid by the debtor in two lump-sum payments. Memorandum of the United States at 3, *Crest Finance Co.* v. *United States*, 368 U.S. 347 (1961). The amount due was the sum of all the advances and accrued interest evidenced by the notes, less the total amount repaid.

---

[49]Reasonable attorney's fees covered by a perfected security interest also should be treated as choate, in the same manner as interest accruals. This Court's rulings in *United States* v. *Pioneer American Ins. Co.*, 374 U.S. 84 (1963) and *United States* v. *Equitable Life Assurance Soc'y of the United States*, 384 U.S. 323 (1966) holding such fees inchoate in a federal tax lien priority contest were superseded by the 1966 Federal Tax Lien Act, 26 U.S.C. § 6323 *et seq.* (1976). Among other things, those amendments provided that attorney's fees incurred in enforcing a lien or security interest which has priority shall enjoy that same priority, despite the fact that they might be characterized as inchoate. 26 U.S.C. § 6323(e)(3) (1976).

[50]Petitioner's Brief at 55 n.60. *See also id.* at 42 n.48. Even in a situation where a debt is represented by a single note or bookkeeping entry, there will be factors which will affect the actual amount owed, such as periodic payments, set-offs, subsequent oral modifications, interest accruals, disputes over interpretations of terms, and the like.

[51]The Conference appeared as *amicus curiae* in the *Crest Finance* case in this Court and before the court of appeals.

The amount of the indebtedness, although fixed and certain, could not be ascertained from the notes in *Crest Finance* any more than from the notes in this case. The amount owed Kimbell by O.K. was the sum of the sales to O.K. less payments made by O.K. That amount was every bit as certain as the debt in *Crest Finance* and was determined in exactly the same manner—from the books and records of the parties.

The position taken by the government in its brief on the standard of choateness, and its reliance upon *United States* v. *R. F. Ball Construction Co.*, 355 U.S. 587 (1958),[52] is completely inconsistent with its position in *Crest Finance*, where it confessed error. In distinguishing the *Ball Construction* case, the Solicitor General stated:

> The issue [in *Ball Construction*] was whether an open-ended assignment, purporting to secure future contingent liabilities, was effective to give the assignee priority for *an indebtedness that did not come into existence until after the federal tax lien arose and was recorded*. This Court properly held that it did not, but that decision is in no way dispositive of this case, for here the indebtedness secured by the lien arose from advances made contemporaneously with the assignments. *The difference between this case and* Ball, *in short, is that at the time the tax lien arose the indebtedness secured by the competing lien was, in* Ball, *not yet in existence and, in this case, fully liquidated.*

Memorandum for the United States at 7, *Crest Finance Co.* v. *United States*, 368 U.S. 347 (1961) (emphasis added).

In contending that O.K.'s debt to Kimbell was not sufficiently certain in January, 1971, the government relies on the argument that the amount of a debt cannot be certain until it is reduced to judgment or enforceable by summary proceedings, in spite of the clear holding to the contrary in

---

[52]Petitioner's Brief at 53.

Crest Finance.[53] It is clear that no judgment is required to make a fixed contractual debt of this kind certain in amount, as distinguished from a statutory lien securing an unliquidated debt. The government's theory is yet another example of the kind of confusion which has been engendered by the choateness concept.

None of the cases cited by the government (Petitioner's Brief at 54–55) suggest that a judgment is necessary to establish certainty for purposes of the choateness test, particularly for a contractual debt. *See Crest Finance. New Britain* simply states the general requirement of certainty, and despite the fact that the state and local tax liens involved there had not been reduced to judgment, the Court remanded the case for a determination of their choateness. *United States* v. *White Bear Brewing Co.*,[54] *United States* v.

[53]Since the government's first claim as a secured creditor arose on February 3, 1971, after the last shipment of goods to O.K. from Kimbell, this case does not involve the viability of either future advance clauses or after-acquired property clauses under the choateness doctrine. Such clauses are fully authorized by the Code and have been for many years a common and accepted part of modern commercial financing practice. Powerful reasons of logic and established commercial practice exist for treating the debt and collateral covered by such clauses in the same manner as the initial debt and collateral, for purposes of the choate lien test. Even in the bankruptcy preference context, where the courts have limited flexibility because they are interpreting statutes rather than formulating judicial rules, interests in after-acquired collateral arising during the preference period of Section 60 of the Bankruptcy Act have been treated as perfected as of the initial date of perfection of the security interests in question. *See, e.g., In re King-Porter Co.*, 446 F.2d 722 (5th Cir. 1971); *DuBay* v. *Williams*, 417 F.2d 1277 (9th Cir. 1969); *Grain Merchants of Indiana, Inc.* v. *Union Bank & Sav. Co.*, 408 F.2d 209 (7th Cir.), *cert. denied sub nom. France* v. *Union Bank & Sav. Co.*, 396 U.S. 827 (1969). The same result is embodied in Section 547 of the Bankruptcy Act of 1978, which is awaiting the President's signature. After acquired security interests in accounts and inventory are protected as long as the secured party does not improve its position at the expense of the estate.

[54]350 U.S. 1010 (1956).

Vorreiter,[55] and *United States* v. *Col[illegible]a*,[56] were all *per curiam* reversals which did not state the basis for the decisions, so that it is unclear what the fatal flaw was in those cases. Furthermore, all three cases involved competitions between federal tax liens and mechanics' liens, rather than between contractual U.C.C. security interests. While the amount actually recoverable under a state-created mechanic's lien may often be unliquidated or the subject of dispute and the vagaries of state law, no such uncertainty exists with a U.C.C. security interest in a contractual commercial credit setting, such as is involved here. Accordingly, there is nothing in those cases to suggest that Kimbell's claim had to be reduced to judgment in order for it to be certain.

In both *United States* v. *Pioneer American Insurance Co.*, 374 U.S. 84 (1963) and *United States* v. *Equitable Life Assurance Society of the United States*, 384 U.S. 323 (1966), the government conceded the choateness and seniority of prior perfected real estate mortgages which had not been reduced to judgment. The government contested only the choateness of the attorneys' fees in those cases. Similarly, in *Crest Finance* the government conceded and this Court held that the unpaid balance of a series of secured loans was choate, despite the fact that the amount was not reduced to judgment prior to the filing of the notice of tax lien.

There is simply no requirement under the choate lien test that a contractual obligation, liquidated in amount, must be reduced to judgment in order for the security interest which secures it to be deemed choate. If adopted by this Court, the government's proposition that a judgment is necessary to make this secured debt certain and choate would mean that there is no such thing as a choate security interest, and that virtually the only possible choate lien is a judgment lien.

[55]355 U.S. 15 (1957).

[56]350 U.S. 808 (1955).

CONCLUSION

Programs of financial aid to businesses, funded by the federal government and administered by its agencies, have grown rapidly in recent decades. These programs supplement the amount of credit otherwise available to these businesses, and are reflections of public policy decisions to support particular segments of commerce in this country.

The role of the government agencies in these programs is the same as private commercial creditors, with discretion concerning when and on what terms to extend credit. In that sense, the traditional conception of the government's sovereign function as an involuntary creditor seeking to collect claims for unpaid taxes is not a useful basis for resolving questions of priority between voluntary federal commercial secured claims and secured claims of other commercial lenders.

The Conference does not question the policies underlying such federal programs or seek any advantage for private secured lenders in priority contests with agencies administering such programs. The Conference asks only that the well understood, comprehensive and fair priority rules of Article 9 of the U.C.C., upon which the entire commercial financing industry relies, not be made meaningless by extending the choate lien test beyond its statutory basis.

Public notoriety by filing, or comparable means to prevent deception, are at the heart of the perfection and priority concepts of the Code. If the government prevails here, reasonable expectations as to the priority of perfected security interests of the banking and commercial segments of this country, based on their reliance upon public filing or other antideceptive rules, would be destroyed by granting special superpriority status to subsequent federal secured claims. Except for pure speculation, no basis would exist for knowing whether or when federal credit might be extended and

become retroactively senior to existing secured interests. There is no practical method of protecting existing investments under these circumstances.

The choate lien test, whatever its strengths and weaknesses in other contexts, has no place in the resolution of priorities among perfected security interests arising under the Uniform Commercial Code, even those granted to or purchased by the government. The Congress recognized this in the tax lien area in 1966, when it responded to heavy criticism of the choateness doctrine by virtually abolishing the choate lien test as applied to perfected security interests.

The formula which puts all secured lenders on an equal footing and facilitates their business planning is that which is embodied in the Code. The Code represents a national law of commerce, and has received explicit recognition from Congress by its adoption of the Code for the District of Columbia and its protection of Code security interests in the Federal Tax Lien Act of 1966. It is to perfection under the U.C.C., rather than the choate lien test, that this Court should look to determine the relative priority of security interests. Accordingly, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

A. Bruce Schimberg
Robert D. McLean
William F. Lloyd
Michael J. Sweeney
Sidley & Austin
One First National Plaza
Chicago, Illinois 60603
Attorneys for Amicus Curiae
National Commercial Finance
Conference, Inc.

October 25, 1978